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BEFORE THE ARIZONA CORPORATION COMMISSION

Arizona Corporation Commission
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COMMISSIONERS

JEFF HATCH-MILLER, Chairman
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IN THE MATTER OF THE APPLICATION OF CHAPARRAL CITY WATER COMPANY, AN ARIZONA CORPORATION, FOR A DETERMINATION OF THE CURRENT FAIR VALUE OF ITS UTILITY PLANT AND PROPERTY AND FOR INCREASES IN ITS RATES AND CHARGES FOR UTILITY SERVICE BASED THEREON.	DOCKET NO. W-02113A-04-0616 DECISION NO. 68176 **OPINION AND ORDER**
DATE OF PRE-HEARING CONFERENCE:	May 26,2005
DATE OF HEARING:	May 31, June 1, June 6 and June 8,2005
PLACE OF HEARING:	Phoenix, Arizona
ADMINISTRATIVE LAW JUDGE:	Teena Wolfe
IN ATTENDANCE:	Kristen K. Mayes, Commissioner
APPEARANCES:	Norman D. James and Jay L. Shapiro, FENNEMORE CRAIG, on behalf of Chaparral City Water Company; Daniel Pozefsky, on behalf of the Residential Utility Consumer Office; and David Ronald, Staff Attorney, Legal Division, on behalf of the Utilities Division of the Arizona Corporation Commission.

BY THE COMMISSION:

I. INTRODUCTION

A. Procedural History

On August 24, 2004, Chaparral City Water Company ("Chaparral City" or "Company") filed with the Arizona Corporation Commission ("Commission") an application for a determination of the current fair value of its utility plant and property and for increases in its rates and charges for utility

service based thereon.

On September 14, 2004, the Residential Utility Consumer Office ("RUCO") filed an Application to Intervene, which was granted.

On September 23, 2004, the Commission's Utilities Division Staff ("Staff') filed a letter stating that the Company's application met the sufficiency requirements set forth in A.A.C. R14-2-103, and classifying the Company as a Class **A** utility.

On September 28, 2005, a Rate Case Procedural Order was issued setting a hearing date and setting procedural deadlines for public notice, intervention, discovery, and for prefiling direct, rebuttal, surrebuttal and rejoinder testimony.

On February 15,2005, the Company filed a Notice of Publication certifying that public notice was published in *The Fountain Hills Times* on January 26,2005. Public notice of the application and hearing was also mailed to each of the Company's customers in their January 2005 bills. Written public comments in opposition to the rate increase were received as set forth herein. Aside fi-om RUCO, no other party requested intervention.

A hearing was held as scheduled before a duly authorized Administrative Law Judge of the Commission, commencing on May 31, 2005 and continuing on June 1, June *6* and June 8, 2005. Public comment was taken at the commencement of the hearing. The Company, RUCO, and Staff appeared and presented evidence at the hearing. Following the filing of closing briefs on July 6, 2005, and reply briefs on July 20, 2005, the matter was taken under advisement pending the submission of a Recommended Opinion and Order to the Commission. On July 28, 2005, the Company filed a Request for Official Notice of Rate Increases Requested by Arizona Public Service Company and Salt River Project.

B. Rate Application

Chaparral City is an Arizona corporation wholly owned by American States Water Company

("American States"), which is publicly traded on the New York Stock Exchange. American States primary operating subsidiary is Southern California Water Company. In October 2000, as approvec by this Commission in Decision No. 62909 (September 18, 2000), American States purchasec Chaparral City's stock from MCO Properties, Inc. ("MCO"), the real estate developer that owned anc operated the Company. Chaparral City provides water utility service to approximately 12,000 customers located in the northeastern portion of the Phoenix metropolitan area, including the Town of Fountain Hills and a small portion of the City of Scottsdale. The majority of the Company's approximately 11,340 residential customers during the test year were served by %-inch meters, but approximately 3,000 residential customers have larger meters. During the test year, the Company also provided service to over 300 commercial customers and over 400 irrigation customers.

The application is based on a test year ended December 31,2003. The Company is requesting an increase in revenues of $1,773,091, or 28.59 percent, for a total revenue requirement of $7,795,935. This revenue requirement is lower than that requested in the application due to the Company's adoption of a number of adjustments recommended by Staff and RUCO, and other adjustments the Company made. RUCO is recommending an increase in revenues of $603,988, or 9.74 percent, for a total revenue requirement of $6,803,753. Staff is recommending a revenue increase of $809,692, or 13.05 percent, for a total revenue requirement of $7,012,536. Based on adjustments to the Company's filing as set forth herein, we authorize an increase in revenues of $1,107,620, an increase of 17.86 percent, for a total revenue requirement of $7,310,464.

I. RATE BASE

A. Plant in Service

The Company is proposing a total of $42,538,338 for plant in service relating to its Original Cost Rate Base ("OCRB") (Bourassa Rj. Sched. B-1). Of that amount, $ 2,979,239 represents plant additions placed in service after the test year: $2,038,443 for the expansion of its Shea Water

Treatment Plant ("Shea WTP"), and $940,979 related to the Fountain Hills Boulevard transmission main (Bourassa Rb. Sched. B-2).

1. Shea Water Treatment Plant Expansion

The Company is requesting rate base treatment of $2,038,442 for the Shea WTP expansion The expansion was begun in 2003 and brought on line in March 2004. The Company has two facilities that are used to treat its CAP water allocation. The Company's original treatment facility is a package plant with a current treatment capacity of about 3 million gallons per day ("gpd"). The Shea WTP consists of three separate treatment modules, each module having a treatment capacity of 5 million gpd. The first module was brought on line in 1996, and the expansion includes the final two treatment modules. The Company had planned to bring these modules on line before the end of the 2003 test year but was delayed in obtaining final regulatory approvals. The Company argues on brief that prior to its acquisition of the Chaparral City system, the prior owner had ignored growth and that as a result, the Company lacked sufficient operational flexibility in its water treatment facilities to perform routine repairs and maintenance or address emergencies. From the years 1995 through 2001, no additional treatment capacity was constructed, despite the fact that the Company added over 4,400 customers, for an average growth rate of ten percent per year (Hanford Rj. at **2,** iting Scott Dt., Exhibit MSJ at 13). During the test year, the Company's peak demand exceeded 10 iillion gpd but it could treat only 8 million gpd of CAP water (Tr. at 63).

RUCO does not oppose the inclusion of the Shea WTP in rate base. According to RUCO's witness, the full Shea WTP capacity was required for water provisioning to the test year customer ase, and the Company's construction costs were known and measurable, and paid, during the test ear (Moore Dt. at 12). RUCO is recommending that the total actual cost of $2,038,443 be allowed n rate base as post-test year plant *(Id.)*.

Staff disagrees with the Company and RUCO, arguing that the Shea WTP is not revenue

neutral as it was not needed during the test year (Moe Dt. at 10), and is recommending its exclusion from test year plant in service. Staff asserts that because the Shea WTP expansion increases treatment capacity, increased revenues from water sales are possible, and that no corresponding increase in test year revenues was made to account for this possibility; that the Company was able to meet peak demand in the test year using groundwater as a supplement to its CAP allocation; and that the Company will benefit more than the ratepayers from the additional protection against outages that the increased treatment capacity will provide. However, it appears that if the expansion had been placed in service during the test year, just three months earlier, Staff would have allowed it in rate base (see Bourassa Rj. at Exhibit TJB-2, Staff Data Response 3-17).

As Staff argued on brief in support of its recommendation to include the post-test year Fountain Hills Boulevard transmission main in rate base, inclusion of post-test year plant always causes some mismatch between revenues and expenses, even if post-test year plant is revenue neutral, ised and useful, and the value of the additions is known (see Staff Cl. Br. at **2-3).** Therefore, even hough quantification of the inevitable mismatch may not be possible, the significance of the nismatch requires careful consideration (see ***id.).*** Given that ninety percent of the Company's water supply comes from *CAP* water, which must be treated before it can be delivered to customers for potable purposes, the ability of the Company to reliably treat its test year CAP water supply is an important factor that weighs heavily in our consideration of whether to include the Shea WTP expansion in rate base. We find that the weight of the evidence in this proceeding supports the Company's assertion that the Shea WTP expansion, which the Company paid for during the test year, ad has been used and useful since March of 2004, allows the Company to reliably meet test year peak demands during the summer months with CAP water, which is a renewable resource we wish to ncourage, while retaining the ability to take individual modules off line for repairs and to meet emergency needs. We find credible the Company's assertion that prior to the Shea WTP expansion,

the Company had been operating with minimal flexibility for routine maintenance and repairs and had no operating safety margin in the event of a need to shut down some of its treatment facilities. These factors support, in this particular case, treating the Shea WTP expansion, which was paid for during the test year and placed in service within three months following the test year, as if it were actually in service at the end of the test year. We will therefore adopt RUCO's recommendation that the total actual cost of $2,038,443 associated with the Shea WTP be allowed in rate base.

2. Fountain Hills Boulevard Main

The Company also requests inclusion of $940,797 in rate base for the Company's share of the cost of installing the Fountain Hills Boulevard main. The Fountain Hills Boulevard main is a 16-inch water transmission main approximately two miles in length, that was placed in service in November 2004. Because a portion of this main was constructed in connection with new development, part of its cost was paid by the developer.

RUCO objects to including the full amount of the Company's cost associated with the main in rate base. RUCO claims that installation of the main results in operating expense savings due to reduced pumping costs, and that the Company's request does not account for the purported savings (RUCO Cl. Br. at 5-6). RUCO did not calculate the savings it alleges, arguing that the burden is on the Company to establish the plant value, taking into account both the cost and the savings (*Id.*, fn 4).

Staff recommends that the Fountain Hills Boulevard main be included in rate base. Staff states that the main addition provides operational flexibility and improved service to customers (Scott Dt., Exhibit MSJ at 7); that it will assist in providing CAP water flow to blend with the Company's Well Number 10 groundwater source in order to reduce the arsenic concentration in water from that well *(Id.);* and that any revenues that would potentially come from the transmission line would be incidental (Moe Dt. at 10). Staffs engineering witness testified that there are no pumping cost savings associated with the new main, because its installation does not result in changes in the way

the system is operated (Tr. at 635-638).

The Fountain Hills Boulevard transmission main has been used and useful since November 2004, providing operational flexibility and improved service to customers. The weight of the evidence does not demonstrate a reduction in operating costs attributable to its operation that would necessitate a reduction in its cost. Based on the evidence presented, we find that the Company's cost associated with the Fountain Hills Boulevard transmission main, $940,797, should be included in rate base.

3. CAP Hook-Up Fees

In the Company's last rate case, Decision No. 57395 (May 23, 1991), the Commission ordered that a portion of the revenue requirement determined in that case be recovered by means of hook-up fees from new customers due to the unique circumstance that the required revenue increase was due primarily to CAP facilities coming on line (see pages 4-5 of Decision No. 57395). In its current application, the Company proposes that the entirety of its revenue requirement be recovered in accordance with traditional rate making principles, through customers' rates. Chaparral City made an accounting adjustment to remove $220,000 in test year hook-up fees from test year revenues (Kozoman Dt. Sched. H-1). All the parties to this case are in agreement that the hook-up fees should no longer be treated as revenues.

RUCO proposes that an adjustment also be made to increase test year contributions-in-aid of construction ("CIAC") by $220,000, the amount of test year hook-up fees, which would reduce the Company's rate base by $220,000. RUCO argues that this adjustment is necessary in order to recognize that hook-up fees financed $220,000 of plant during the test year. The Company objects to this adjustment, because it does not include a corresponding $220,000 adjustment to the asset side of the balance sheet.

RUCO's proposal assumes that the $220,000 collected during the test year as hook-up fees

was used to pay for plant additions. In most circumstances, such an assumption would be correct, because this Commission normally limits the use of hook-up fees to the installation of utility plant. However, as described by the Company's witness (Tr. at 829-832), Decision No. 57395 did not limit the use of the authorized "hook-up fees" to plant investment, but clearly intended that the "hook-up fees" be treated as operating revenues (Decision No. 57395 at 5-6). The $220,000 represents test year revenue and not plant additions. RUCO's proposed adjustment is therefore unnecessary and will not be adopted.

The Company does not have an approved hook-up fee tariff on file at this time. We will require the Company to file a hook-up fee tariff, and to obtain Commission approval of the tariff prior to collecting any hook-up fees on a going-forward basis.

4. Reclassification of Expenses to Plant in Service

RUCO recommends the removal of $5,686 of repairs and maintenance expense associated with water treatment plant. The Company proposes that the expense be reclassified as water treatment plant and Staff agrees. This proposal is reasonable and will be adopted.

Staff recommends that $26,850 from outside services expense be reclassified to meters and pumping equipment. The Company agrees with this recommendation, which is reasonable and will be adopted.

B. Accumulated Depreciation

The Company proposes an adjustment to decrease accumulated depreciation by $11,421, in order to correct for an error in the Company's filing (Co. Rb. Sched. B-2 at 3). Staff proposed additional adjustments to accumulated depreciation associated with the reclassification of expenses to plant in service discussed above, and with the removal of vehicles from plant in service as agreed to by the Company. These adjustments are reasonable and will be adopted, for total accumulated depreciation of $11,980,749.

III. ORIGINAL COST RATE BASE

With the adjustments discussed above, test year plant in service is $42,539,165, and deducting accumulated depreciation results in net plant in service of $30,558,416. As proposed by the Company, test year net CIAC is $258,143, advances in aid of construction ("AIAC") is $10,327,171. customer deposits are $1,070,331, and deferred income tax credits are $1,872,006. Deducting these items from net plant in service results in an adjusted original cost rate base ("OCRB") for ratemaking purposes of $17,030,765.

IV. RECONSTRUCTION COST NEW RATE BASE

Chaparral City submitted schedules reflecting both an OCRB and an estimated reconstruction cost new less depreciation ("RCND") rate base. Staff reviewed the Company's RCN study and agreed with the Company's plant in service values (Scott Dt., Exhibit MSJ at 6). The adjustments discussed above and reflected in our determination of OCRB are equally applicable to the Company's proposed RCND. Based on the foregoing discussion, we therefore adopt an adjusted RCND for ratemaking purposes of $23,649,830.

V. FAIR VALUE RATE BASE

Chaparral City is proposing a FVRB based on the average of its OCRB and RCND. Staff also utilized this approach. RUCO recommends a FVRB equal to its OCRB. We find that the average of the adjusted OCRB and RCND provides a reasonable measurement of the current value of the Company's property dedicated to public service. Based upon a 50/50 weighting of the OCRB and RCND, we find Chaparral City's FVRB at December 31,2003 to be $20,340,298. The rate of return to be applied to FVRB is discussed in Section VIII below.

VI. OPERATING INCOME

A. Expenses

Several adjustments to operating expenses that Staff and RUCO proposed were either agreed

to by the Company prior to the hearing or were not addressed on brief by the Company.[1] We find those proposed adjustments to be reasonable and they will be adopted. Remaining contested operating expense issues are addressed below.

1. Expense Normalization

Staff proposes normalization adjustments in several accounts in which Staff believes test year expenses were not representative of a normal year. The expense accounts to which Staff proposes normalization adjustments are office expenses, outside services, transportation expenses, and miscellaneous expenses. Staff asserts that while operating expenses normally remain fairly stable From year to year, a ratio analysis reveals that the test year expenses in these accounts show a dramatic change from prior years and are not reflective of normal expense levels (Tr. at 731; Moe Sb. at 6). Due to the significant fluctuation in expenses in these accounts, Staff recommends that the actual 2003 test year expense amounts in these accounts be normalized by averaging them with the ictual expense amounts incurred in the years 2001 and 2002, in order to mitigate any extenuating circumstances leading to the test year expense levels (Moe Dt. at 14-18; Tr. at 815-16).

Chaparral City advocates for the use of actual test year expenses. The Company claims that Staff's normalization adjustment is not based on known and measurable changes in expenses, and asserts that the averages will produce unrealistic results on a going forward basis (Bourassa Rb. at 33). The Company asserts that 2001 and 2002 expense levels do not reflect current operating expense levels because it took until 2003 for the Company to get its operations up to the current level of system reliability after acquiring the system fi-om MCO in late 2000 (Hanford Rj. at 7-8).

Test year expenses are used to estimate the level of expense that a Company will experience during the period that rates will be in effect. Normalization of expenses is an appropriate ratemaking tool that insures that unusual levels of expense in a test year do not skew expense recovery, and is

[1] The parties were informed that issues not briefed would be assumed waived. See Transcript of Pre-hearing Conference at 11.

used not only in cases where test year expenses are abnormally high, but also in cases where test year expenses are abnormally low. In this case, the evidence presented shows test year expenses in these four accounts to be abnormally high. The 2001 and 2002 expense levels in these accounts are known and measurable. Averaging these known and measurable amounts with the unusually high 2003 test year levels recognize the "across the board increase in expenses" the Company claims has occurred, while producing a realistic estimate of reasonable expenses in these accounts on a going-forward basis. Chaparral City argues that use of year 2004 expenses would have illustrated whether the 2003 expense levels were unusual, or reflect operating expense levels on a going forward basis (Co. Br. at 19). However, because the Company did not provide a comparison of 2004 expenses to test year expenses (Tr. at 732), its argument is speculative. Based on the record evidence, we find it appropriate to normalize the test year level of expenses in these four accounts. Staffs recommendation is reasonable and will be adopted.

2. Legal Expense Related to Purchase from MCO

RUCO recommends that the legal expenses associated with the purchase of the Company from MCO be disallowed from test year outside services expenses because they were unique and not a typical or recurring expense. Chaparral City concedes that the same legal matters resulting in expense during the test year may not reoccur, but that the test year reflects a level of annual legal expenses that a utility of the Company's size is likely to incur in the future (Bourassa Rb. at 35-36; Bourassa Rj. at 22). The legal expenses in question are included in outside services expense, which will be normalized, as discussed above. We find that the normalization of test year outside services expense addresses this issue appropriately and that no further adjustment is necessary.

3. Tank Inspection and Cleaning Expense

The Company proposes to remove operating expenses of $35,400 incurred during the test year for tank inspection and cleaning, and to instead amortize and recover those costs over five years at

approximately $7,080 per year (Bourassa Rb. at 31; Rb. Scheds. B-2 at 5 and C-2 at 8). The Company's witness testified that the inspection and cleaning may not be an annual recurring expense, but that it is a prudent and necessary expense incurred in the provision of water services (Bourassa Rb. at 31). RUCO recommends that these costs be disallowed, because they were already recovered through 2003 operating expenses, and the next inspection has not been scheduled (Moore Sb. at 16-17). Staff asserts that its expense normalization adjustment addresses this issue, and recommends that the Company's proposed adjustment not be adopted. We concur with Staff that its normalization adjustment to outside services expense appropriately addresses the issue. Both the disallowance proposed by RUCO and the Company's proposal to amortize this particular expense are therefore unnecessary.

4. Wages and Salaries Expense

The Company, Staff and RUCO proposed that a portion of the Company's wages and salaries expense be capitalized. The capitalization rate for 2003 was 17.46 percent and the 2004 capitalization rate was 17.31 percent (Bourassa Rb. at **30).** The Company and Staff both propose the use of the 2004 capitalization rates, which are known and are the most current rates *(Id.*, Bourassa Rj. at 19; Moe Sb. at 14), which results in proposed wages and salaries expense of $991,217. In arriving at its lower recommended wages and salaries expense of $877,231, RUCO uses the capitalization rate that the Company originally provided to it, and does not accept the corrected capitalization rate the Company later provided. (Moore Sb. at 13). The Company asserts that it originally erroneously provided RUCO the Company's payroll system coded default percentages, and not its actual capitalization rate (Bourassa Rb. at 30, Rj. at 19). We agree with the Company and Staffs use of the 2004 capitalization rate of 17.31 percent, as it reflects known and most current rates, and will adopt their recommended wages and salaries expense of $991,217.

5. Purchased Power Expense

The Company proposes that purchased power expense should be adjusted to take into account ·ecent rate increases of Salt River Project ("SRP") and Arizona Public Service Company ("APS") Bourassa Rj. at 17). Staff agrees with this adjustment (Moe Sb. at 16). RUCO opposes this ıdjustment claiming that the increases in power rates are too far outside the test year (Moore Sb. at 1). The SRP and APS rate increases are known and measurable expenses. The adjustment proposed ›y the Company and Staff is appropriate and will be adopted, for total purchased power expense of $510,947.

6. Property Tax Expense

The Arizona Department of Revenue ("ADOR") determines the value of utility property for ax purposes using a formula that is based on the utility's historical revenues. The Company and ltaff propose to follow recent Commission Decisions[2] to use adjusted test-year revenues in the pplication of the ADOR formula in order to determine allowed property tax expense (Bourassa Rj. t 16; Moe Dt. at 19). RUCO continues to disagree with the Commission's use of adjusted test year evenues in the application of the ADOR formula for estimating property tax expense for ratemaking urposes, and argues that only historical revenues should be used.

In an attempt to support its argument, RUCO compared the results of its methodology, using ıe Company's historical revenues for the years 2001, 2002 and 2003, with the results of the ommission's methodology, using the Company's historical revenues and adjusted test year evenues, in order to predict the property taxes assessed by ADOR in 2004 *(see* Hearing Exhibit R-2), id asserts that because its methodology more accurately predicted the actual 2004 tax assessment,

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E.g., *Rio Rico Utilities,* Decision No. 67279 (October 5, 2004) (finding that use of only historic revenues understates the pense level); *Arizona Water Company,* Decision No. 64282 (December 28,2001) (accepting Arizona Water Company's operty tax calculation, which included proposed revenues); *Bella Vista Water Company,* Decision No. 65350 lovember 1, 2002) (concluding that "the most logical approach is to use the two most recent historic years' revenues, d the projected revenues under the newly approved rates"); *Arizona American Water Company,* Decision No. 67093 me 30,2004).

that the Commission should adopt its approach (RUCO Br. at 8-9). We do not agree. Exhibit R-2 does not, and cannot, include a comparison of results of RUCO's backward-looking methodology with results of the Commission's approach for any years beyond 2004, because the actua assessments for the years following 2004 are unknown. What is known is that any revenue increast approved in this proceeding will increase the Company's property taxes, barring the occurrence o very extraordinary circumstances. ADOR will never again use the inputs of revenues for the years 2001, 2002 and 2003, the years RUCO advocates using in this proceeding, to determine property tax levels for Chaparral City. RUCO's calculation methodology, which uses only historical revenues. unfairly and unreasonably understates property tax expense, and is therefore inappropriate for ratemaking purposes.

As we have repeatedly found, the input of known revenue increases is necessary in order to fairly estimate property tax expense for ratemaking purposes. RUCO has not demonstrated in this proceeding a basis for departure from our prior determinations on this issue.[3] We will therefore adopt the recommendations of the Company and Staff to follow recent Commission Decisions to use adjusted test year revenues in determining property tax expense.

The legislature recently enacted Arizona House Bill 2779, which will gradually lower the assessment ratio for Class 1 properties, such as utility property, from 25 percent to 20 percent over a ten year period, by means of a reduction in the assessment ratio of ½ percent a year. Assessment ratios are applied to full cash value to derive an assessed value on which property tax is applied (Tr. at 643). Although the new assessment ratios are known, their actual effect on the amount of property taxes assessed in the future is unknown, because unlike the assessment ratios which are set by the legislature, actual property tax rates are set by counties and other governmental entities (Tr. at 643, 645). As requested, the parties introduced schedules at the hearing that estimate the impact of HB

[3] RUCO has not appealed prior Commission Decisions rejecting its proposed methodology.

2779 on the Company's property tax expense level (see Hearing Exhibits A-26, R-8, S-15). The schedules show that even if property tax rates were to remain constant, the effect of calculating HE 2779's lower assessment ratios into property tax estimates would have a de minimus effect on rates in this case (see Tr. at 596; 644). No party recommended that its property tax calculation be amended.

Based on the revenue requirement we adopt herein, and utilizing the methodology adopted by the Commission in our prior Decisions for the reasons set forth herein, an allowance will be made for property tax expense in the amount of $299,495.

7. Depreciation Expense

The Company's application showed test year depreciation expense of $920,648. The Company did not perform a depreciation study, but chose instead to base its depreciation rates on Staffs developed typical and customary depreciation rates (Bourassa Rb at 2, Rj. at 17). Based on its proposed plant in service amounts, the Company proposed test year adjusted depreciation expense of $1,432,828 (Bourassa Rj. Sched. C-1, p. 1). Staff accepted the Company's use of Staffs developed typical and customary depreciation rates to calculate its proposed test year adjusted depreciation expense of $1,365,295, based on its proposed plant in service (Moe Sb. Sched. JRM-24). RUCO disagrees with the use of Staffs developed typical and customary depreciation rates and proposes the use of a different set of depreciation rates instead, as discussed in Section XI hereinbelow. Using its proposed depreciation rates, RUCO proposed test year adjusted depreciation expense of $1,113,339, based on its proposed plant in service amounts (Moore Dt. Sched. RLM-10, p. 1 of 2). Applying RUCO's proposed depreciation rates to the plant in service amounts approved herein would result in test year adjusted depreciation expense of approximately $1,139,194. Consistent with our discussion of appropriate depreciation rates in Section XI hereinbelow, we adopt test year adjusted depreciation expense of $1,432,828, based on the plant in service amounts authorized herein and using the depreciation rates proposed by the Company and Staff.

B. Statement of Operating Income

The Company's adjusted test year operating revenues, as agreed by the parties, were $6,202,844. In accordance with the discussion above, the Company's adjusted test year operating expenses for ratemaking purposes total $5,588,597, for an adjusted test year operating income o $614,247.

VII. COST OF CAPITAL

Chaparral City, Staff and RUCO presented cost of capital analyses for purposes of determining a fair value rate of return in this proceeding. The cost of equity proposed by Chaparral City's witness, Dr. Thomas Zepp, translates to a recommended overall weighted average cost of capital of 8.2 percent if its requested automatic adjustment mechanisms for purchased water and purchased power costs are approved, and 8.6 percent if they are not approved. Staff is recommending, based on the analysis of Staff witness Alejandro Ramirez, a weighted average cost of capital of 7.6 percent. Based on the analysis of its witness William Rigsby, RUCO believes the Commission should adopt RUCO's recommended 7.66 percent weighted average cost of capital.

A. Capital Structure and Cost of Debt

1. Capital Structure

The parties are in agreement that the Company's capital structure as of December 31, 2003 should be used to determine the Company's weighted cost of capital, as follows:

Long Term Debt	$ 8,363,309	41.27%
Common Equity	11,901,727	58.73%
Total Capital	$20,265,036	100.00%

2. Cost of Debt

The parties also agree that the Company's cost of long term debt is 5.1 percent, which results n a weighted cost of debt of 2.11 percent.

B. Cost of Equity

Although the cost of debt can be determined from fixed cost rates, the cost assigned to the equity component of the capital structure can only be estimated. The cost of equity recommendations advocated by the parties are: Chaparral City, 10.4 percent if its requested automatic adjustmeni mechanisms for purchased water and purchased power costs are approved, and 11.0 percent if they ure not approved; RUCO, 9.45 percent; and Staff, 9.3 percent.

1. Chaparral City

Chaparral City's witness, Dr. Zepp, prepared estimates of the cost of equity based on the liscounted cash flow ("DCF") model used by the Federal Energy Regulatory Commission ("FERC") ind the risk premium method used by the staff of the California Public Utility Commission ("CPUC taff"). The DCF method of estimating the cost of capital is based on the theory that the present 'alue of a stock is equal to the present value of all expected future dividends or cash flows. The onstant growth DCF model assumes that a company will grow at the same rate indefinitely, while he non-constant growth DCF model does not assume that dividends grow at a constant rate over ime. The constant-growth DCF formula includes three variables used to estimate the cost of equity:) the expected annual dividend; 2) the current stock price; and 3) the expected infinite annual growth ate of dividends ("dividend growth rate"). The constant-growth DCF model calculates a dividend ield by dividing the expected annual dividend by the current stock price, and then adds the resulting ividend yield *to* the expected infinite annual growth rate of dividends. The Company prefers ERC's constant growth DCF method to the constant growth DCF method used by Commission taff, because the FERC's method eliminates from consideration any individual utility equity cost stimate that is not at least forty basis points above the cost of investment grade bonds (Zepp Dt. at 4, 30). The Company argues that Staffs constant growth methodology, which does not reject such stimates, lowers Staffs average growth inputs for the model and its resulting equity cost estimate

(Zepp Rj. at 10-13). The Company also advocates use of the risk premium method used by the CPUC staff to estimate the cost of equity instead of the capital asset pricing model ("CAPM") used by Commission Staff, because the CPUC staffs risk premium approach estimates the risk premium by comparing authorized and actual returns on equity ("ROE") with the current yield of investment grade bonds or other debt instruments (Zepp Dt. at 4-5 and 33-34). Using these methods, Dr. Zepp presented updated equity cost estimates in his rejoinder testimony that range from 10.4 percent to 10.9 percent based on the six publicly-traded water utilities included in the sample group.[4] Using the CPUC staffs risk premium approach and interest forecasts, rather than current interest rates, the Company estimated the cost of equity for the water utility sample at 10.5 percent to 10.7 percent (Zepp Rj. at 7-8 and Rejoinder Table 6). Dr. Zepp's analysis included a study of authorized ROEs for the sample group of water utilities, which range from 9.7 percent to 12.7 percent, for an average of 10.4 percent, and looked at the returns on equity actually being earned by those water utilities, which averaged 10.0 percent. Dr. Zepp also cited ***Value*** *Line*, a source of financial data to which all the parties referred in their analyses, for ***Value*** *Line's* projections of returns on common equity of 11.0 percent, 11.5 percent and 12.0 percent for 2005, 2006 and 2008-2010, respectively, for the water utility industry. Dr. Zepp claims that these measures of the cost of equity indicate an equity cost of greater than 10.0 percent for the sample utilities and, he asserts, a higher equity return for Chaparral City, based on his belief that the Company is more risky.

The Company is critical of Staffs implementation of the DCF model, because instead of relying solely on forward-looking estimates of growth, Staff gives a 50 percent weight to historic growth data from 1994-2003, which results in a lower dividend growth rate and a lower equity cost

[4] The Company and Staff used the same six publicly-traded water utilities as proxies in their analyses: American States Water (Chaparral City's parent), Aqua America, California Water Service, Connecticut Water Services, Middlesex Water Company and SJW Corp. RUCO used the three largest publicly-traded water utilities in this group in its analysis: American States Water, Aqua America and California Water Service. These companies represent the water utilities that are currently analyzed by the *The Value Line Investment Survey Small and Mid* ***Cap*** *Edition* and *The Value Line Investment Survey ("Value Line").*

e estimate. The Company also argues that Staffs historic dividend growth rates are extremely low, and p produce results that are in some cases below the cost of an investment grade bond (see Hearing E Exhibit A-23), and that Staffs application of the average dividend yield to compute its equity cost "masks" this fact. Dr. Zepp advocates the use of future, rather than historic growth rates, based on h his belief that forecasts already incorporate the historic information used by Staff (Zepp Dt. at 25). T The Company believes that giving 50 percent weight to historic growth rates double counts what has h happened in the past, and that investors are more interested in a stock's future performance than its p past performance. The Company states that it therefore prefers the forward-looking approach used by t he FERC (Co. Br. at 36). In rejoinder testimony, Dr. Zepp restated Staff witness Ramirez' constant g growth DCF model estimate, using the average dividend yield (3.3 percent) and an average of Mr. R Ramirez' projected growth rates (7.5 percent), and reached a result of 10.8 percent which is virtually i dentical to Dr. Zepp's updated estimate using the FERC one-step method, 10.9 percent (Zepp Rj. at 1 0). Dr. Zepp also restated Staffs multi-stage DCF estimate using Staffs data but also including S Staff's 8.7 percent estimate of intrinsic growth which Staff used in a different model and also used a d ifferent terminal, second stage growth rate. The results of Dr. Zepp's restatement is a cost of equity e stimate of 10.1 percent (Zepp Rj. at 14). The Company states that the multi-stage DCF model that S Staff uses is similar to the two-step DCF model FERC uses, but is critical of the choices Staff made t o implement its model, such as the assumption that average growth will initially be only 3.7 percent, a nd after 2008, will be 6.5 percent. The Company prefers the assumption in the FERC model that it will take many years before the terminal growth rate will be the same as gross domestic product ("GDP") growth, and the fact that the model therefore gives greater weight to the estimate of near t erm, stage 1 growth. As for stage 2 growth estimates, the Company also prefers to use the geometric a verage annual GDP growth rate, which is 6.4 percent, rather than Staffs use of the arithmetic a verage annual GDP growth rate, which is 6.8 percent. The inputs preferred by Dr. Zepp lead to

higher equity cost estimates.

The Company also finds Staffs use of the CAPM model in estimating its equity cos problematic. Dr. Zepp criticizes the Staffs assumption in the CAPM that Chaparral City has the same beta[5] as the average beta of the six publicly traded water utilities in the sample group, 0.68 because, in his opinion, Chaparral City is a more risky operation than the public utilities in the sample group and would have a beta closer to 1.0, which would result in a higher equity cost estimate (Zepp Rb. at 22). Dr. Zepp is also critical of Staffs selection of the average yield on five, seven and ten year Treasury Securities for its risk-free rate, on the basis that most investors hold securities for a five :o ten year period (see Ramirez Dt. at 26-27). The Company argues that the investors' holding period s not relevant, and Staffs choice reduces the equity cost estimate. The Company would instead)refer the use of a long-term Treasury Bond rate as the risk-fi-ee rate (Zepp Rb. at 18-19). The Company further argues that although Staff has used an average of intermediate-term Treasury rates is the risk-free rate, Staff used the long-term Treasury rate to estimate the market risk premium and :laims that this creates a mismatch (Zepp Rj. at 15). The Company also argues that recent empirical :tudies of the CAPM have shown that the returns estimated for low data stocks like the water utility ample group are too low relative to required returns for average risk stocks (Tr. at 245), and quotes n article published last year by Drs. Eugene Fama and Kenneth French which concludes that despite its seductive simplicity, the CAPM's empirical problems probably invalidate its use in pplications."[6] On rejoinder, Dr. Zepp restated Staffs CAPM equity cost estimates using its referred inputs, and reached an equity cost estimate of 10.2 percent (Zepp Rj. at 15-17). The Company argues that this updated CAPM estimate is conservative for the reasons stated in its riticism of the CAPM.

[5] Beta measures the systematic risk of a company. The market's beta is 1.0; therefore, a security with a beta higher than .0 is riskier than the market, and a security with a beta lower than 1.0 is less risky than the market.

[6] Eugene F. Fama and Kenneth R. French, "The Capital Asset Pricing Model: Theory and Evidence" 18 *Journal of conomic Perspectives* 25-46 (Summer 2004).

While the Company does not disagree regarding the basic formula RUCO used to derive its Sustainable growth rate to derive its estimate of dividend growth, the Company argues that RUCO's witness Rigsby's reliance on his personal analysis of *Value Line* forecasts depresses his dividend growth estimate and reduces the equity cost produced by Mr. Rigsby's DCF model (Zepp Rb. at 31-33; Tr. at 296-99). Dr. Zepp claims that RUCO's dividend growth estimate is flawed in that its external "sv" growth rate includes an understated estimate of the stock financing rate ("s") compared to forecasted stock financing rates (Zepp Rb. at 32, Rebuttal Table 15). Dr. Zepp is also critical of RUCO's estimates of the "v" in its external growth rate, and asserts that that there is no evidence supporting Mr. Rigsby's opinion, based on Dr. Morin's text on regulatory finance *(see* Hearing Exhibit A-16), that the market prices of a utility stock will move toward book value. Using equity cost estimates based on Mr. Rigsby's data, but using different inputs, Dr. Zepp produced a restatement of RUCO's constant growth DCF model in two different ways. Dr. Zepp used RUCO's dividend yields, adjusted RUCO's historical average retention growth rate ("br") growth rate and stock financing ("vs") growth rate estimates to reach an equity cost of 10.7 percent (Zepp Rb. at 31-33 and Rebuttal Tables 15 and 16). Dr. Zepp performed another restatement of RUCO's DCF analysis using forecasts of growth instead of sustainable growth and reached an equity cost estimate of 10.6 percent (Zepp Rj. at 22 and Rejoinder Table 9).

2. Staff

Staffs witness Ramirez prepared estimates of the cost of equity using market-based models: constant-growth DCF model, a multi-stage, or non-constant growth DCF model, and a CAPM analysis. To calculate dividend yield in its constant-growth DCF calculation, Staff divided the expected annual dividend as forecasted by *Value Line* by the spot stock price on April 20, 2005. Staff states that it used a spot stock price, rather than a historical average of stock prices, in order to be consistent with the efficient markets hypothesis of finance theory, which holds that the current

stock price includes investors' expectations of future returns and is the best indicator of those expectations.[7] Staff then added the resulting dividend yield to its estimate of a dividend growth rate. To reach its dividend growth rate determination, Staff used a combination of historical and projected dividend-per-share ("DPS") growth provided by *Value Line*, and also examined historical and projected growth in earnings-per-share ("EPS") and intrinsic growth. Staffs analysis produced an average of historic and projected growth rates of 5.8 percent, which when added to Staffs dividend yield calculation of 3.3 percent, produced Staffs constant growth DCF estimate of 9.1 percent. Staffs multi-stage DCF model incorporates two growth rates; a near term growth rate and a long-term growth rate to account for the assumption that investors expect dividends to grow at a non-constant rate in the near term (stage 1 growth) and then to grow at a constant rate in the long term (stage 2 growth) (Ramirez Dt. at 23). To calculate stage 1 growth, Staff forecasted four years of dividends for each of the utilities in the sample group using *Value Line's* expected dividends for the first year and projected DPS growth rate for the three subsequent years; and to estimate its stage 2 growth, Staff used the 6.5 percent rate of GDP growth from 1929 to 2003, which Staff believes is inappropriate because it assumes that the water industry is expected to grow neither faster nor slower than the overall economy (Ramirez Dt. at 24). Staff reached a multi-stage DCF estimate of 9.5 percent. Staff calculated its overall DCF estimate of 9.3 percent by averaging the results of its constant-growth and multi-stage DCF estimates.

Staff also performed a CAPM analysis using a historical market risk premium estimate, reaching an estimate of 9.1 percent, and a current market risk premium estimate, reaching an estimate of 9.3 percent, to reach its overall CAPM estimate of 9.2 percent (Ramirez Dt. at 25-29). Based on its DCF and CAPM estimates, Staff recommends a cost of equity of 9.3 percent.

[7] Ramirez Dt. at 15. Use of spot market price has been adopted in recent Commission Decisions, including *Arizonn Water Company*, Decision No. 66849 (March 19, 2004), and *Arizona-American Water Company*, Decision No. 67093 June 30,2004).

Staff disagrees with the Company's use of the FERC DCF analysis because it miscalculates dividend yields and relies only on analysts' forecasts, which are overly optimistic (Ramirez Dt. at 40-41). Staff states that the FERC DCF multi-stage analysis relies more heavily on analysts' forecasts than on GDP growth, and asserts that it is more reasonable to rely on the GDP than on analysts' forecasts, which are known to be overly optimistic (Ramirez Dt. at **42-45).** Staff further argues that the FERC multi-stage DCF analysis assumes that the water industry will grow indefinitely at a rate that outpaces the historical GDP growth, which is impossible. Staff also asserts that Dr. Zepp's modification of Staffs multi-stage DCF analysis introduces a supernormal growth stage between stage 1 and stage 2 growth in Staffs model (Ramirez Sb. at 10). Staff addresses Dr. Zepp's criticism of its use of the geometric average, and not the arithmetic average, of GDP growth. Staff states that while the arithmetic mean represents typical performance over single periods, it is more appropriate to use the geometric average because it better represents long-term performance (Ramirez Sb. at 11).

Staff is also critical of Chaparral City's use of the CPUC staffs risk premium analysis to estimate its cost of equity, because the risk premium analysis erroneously assumes that accounting ROEs are equal to the cost of equity. Staff states that this assumption is contrary to the basic proposition in finance that cost of equity is less than the allowed rate of return on equity, and argues that the risk premium analysis used by the CPUC staff is flawed due to its suggestion that investors' actual cost of equity is lower than historical or book ROE. Staff believes that reliance on a risk premium analysis comparing allowed ROEs to the cost of equity is misplaced because it is capital markets, not regulatory commissions, that determine the cost of equity. Staff argues that although certain ROEs may have been allowed in prior regulatory decisions, there are numerous factors which are not always identified in a commission decision that may have influenced the rate of return approved in a particular proceeding; that the particulars behind each case cannot always be known; and that even if the particulars were known, the witnesses who testified in those past cases are not

available for cross-examination in this case (Ramirez Dt. at 51).

Staff is also critical of Dr. Zepp's use of forecasted interest rates, rather than spot market rates, to conduct his risk premium analysis. Staff asserts that Dr. Zepp's reliance on forecasts of ten-year Treasury securities, long-term Treasury securities, and Baa corporate bond rates are biased, and argues that the best forecast of tomorrow's yield is simply today's yield (Ramirez Dt. at 47-49). In response to Dr. Zepp's argument that the sample water companies Staff used are not representative of Chaparral City because Chaparral City has more systematic risk than the sample companies, Staff argues that Chaparral City and the sample water companies are in the same business and should have on average the same systematic risk, and that no evidence was submitted to support the Company's claim otherwise with regard to potential rate base disallowances, existence of or lack of adjustment mechanisms, or transitions to a multi-tier declining block rate design (Ramirez Dt. at 35-39). Staff argues that market risk is related to economy-wide perils that affect all businesses, such as inflation, interest rates and general business cycles, and that unique risk does not affect the cost of equity, because firm-specific risk can be eliminated through shareholder diversification. Staff asserts that its assumption that all water companies have similar betas is therefore reasonable, and states that even if Staff had not performed a CAPM analysis, its cost of equity recommendation would still be 9.3 percent based on its DCF estimates.

3. **RUCO**

RUCO believes that given the current environment of low inflation and low interest rates, its 9.45 percent cost of equity estimate is reasonable; that despite the fact that Chaparral City's equity level is slightly higher than the average of the sample companies (59 percent as compared to 56 percent) RUCO did not make a downward adjustment to its DCF estimates; that its DCF growth rate estimates exceed analysts' growth rates by 49 to 60 basis points; and that its recommended 9.45 percent cost of equity estimate is extremely close to the 9.50 ROE *Value Line* projection for

American States, Chaparral City's parent, for the 2005 operating period (Rigsby Dt. at 41). RUCO i critical of the Company's reliance on securities analysts' projections alone to arrive at its estimates o growth without attributing any significance to historical data, and points out that Mr. Rigsby': estimates take into account the fact that past projections of *Value Line* analysts have tended to b somewhat higher than the actual returns on the common equity of water utilities. RUCO states tha its methodology for determining the "sv" component of Mr. Rigsby's DCF growth figure, rather thar being subjective, as the Company charges, objectively relies on the work of Dr. Roger A. Morin a well as other academics in the field of finance and the resulting theory that the market price of a utility's common stock will move toward book value, or a market to book ratio of 1.0, if regulators allow a rate of return that is equal to the cost of capital (Rigsby Dt. at 16; Tr. at 318-22; Hearing Exhibit A-16). RUCO points out that while the Company believes Mr. Rigsby's growth estimates are oo low, his average "br + sv" growth estimate is 60 basis points higher than the average of *Value Line's* projections on EPS, DPS, and book value per share; that his growth estimate is 185 basis points higher than the average projections of analysts at *Value Line,* and 470 basis points higher than *Value Line's* 5-year average of historical data for the water utilities it follows (Rigsby Dt. at 21).

4. Conclusion

The Company, Staff and RUCO all used a DCF model. The Company's estimates varied ignificantly from Staff and RUCO's estimates due primarily to differences in its dividend growth stimation. We note that while the Company criticized Staff and RUCO for choosing inputs that depressed" their cost of equity estimates, the Company's choices resulted in higher cost of equity stimates. We agree with Staff and RUCO that relying solely on analysts' forecasts of the short-term rowth rate of the water industry may be unreasonable, and believe that averaging past growth rates ith growth rate forecasts produces a more reasonable estimate, because analysts' forecasts are nown to be optimistic. We are not convinced that the methodology FERC uses to estimate cost of

capital for the energy and gas industry companies it regulates is appropriately applied to monopoly water utilities. We disagree with the use of a risk premium analysis for cost of equity estimation for the reasons Staff states, as set forth above. We find, after examining the evidence presented, that Staffs DCF methodology provides a more reasonable cost of equity estimate than the Company's. Staff's analysis is based on sound economic principles, and produces a cost of equity estimate that represents a fair and reasonable estimate of Chaparral City's cost of equity for purposes of this proceeding, and will produce a return commensurate with returns on investment in other enterprises with risk corresponding to that of the Company. As described above, Staff arrived at a 9.3 percent cost of equity estimate through application of both the constant growth and multi-stage DCF models and the CAPM.

C. Cost of Capital Summary

	Percentage	Cost	Weighted Cost
Long-Term Debt	41.2%	5.1%	2.1%
Common Equity	58.8%	9.3%	5.5%
Weighted Average Cost of Capital			7.6%

VIII. RATE OF RETURN

Chaparral City advocates that its proposed cost of capital be adopted as a rate of return to be applied to its FVRB to determine required operating income (Bourassa Rb. at 2). Staff recommends that the weighted average cost of capital be used to determine a fair value rate of return in accordance with the Commission's traditional rate of return methodology. As stated earlier, RUCO recommends that its recommended OCRB be adopted as the Company's FVRB without regard to the Company's FCND, and recommends that its proposed weighted average cost of capital be applied to the resulting FVRB.

The Company claims that both Staff and RUCO "ignored FVRB" when they multiplied their recommended rates of return by their recommended OCRBs to determine Chaparral City's operating

income, and then divided the operating income by the FVRB to compute a fair value rate of return (Co. Br. at 6-7). The Company claims that this methodology results in rates based solely on original cost rather than fair value *(Id.)*. The Company further claims that the approach advocated by Staff and RUCO violates the fair value standard (Co. Br. at 10).

RUCO argues that this Commission has historically and consistently averaged a utility's OCRB and RCND to determine a FVRB and then computed a fair value rate of return to apply to FVRB in calculating operating income (RUCO Reply Br. at 3). RUCO asserts that the Company is attempting to persuade the Commission to approve an operating income methodology that considers rate base and rate of return on two different bases, and that its arguments should be rejected, because if rate base and rate of return are not stated on the same basis, operating income will be overstated (RUCO Br. at 1-2).

Staff states that in this case, Staff has considered and recommended a finding of fair value and a fair rate of return on that fair value. Staff states that in order to ensure that the Company is given the opportunity to earn a fair rate of return on the fair value of its plant, Staff proposed a cost of capital analysis, and based on its analysis, proposed a weighted average cost of capital which, when applied to the Company's OCRB, yields just and reasonable rates. Staff further states that its recommended FVRB similarly provides the Company with an opportunity to earn its cost of capital, and that allowing a higher rate of return on the Company's FVRB than the return Staff recommends would provide the utility with an opportunity to earn windfall profits, and would not yield just and reasonable rates as required by Article XV, Section 3 of the Arizona Constitution (Staff Br. at 8).

We disagree with the Company's assertion that the rate of return methodology used by this Commission to determine revenue requirement violates the fair value standard. The Company attempts to equate the weighted average cost of capital to a rate of return, when in fact, this cost of capital estimate is used as a tool to determine a just and reasonable rate of return. The rate of return

methodology and resulting revenue increase proposed by Chaparral City would produce an excessive return on FVRB. There has been no legitimate basis presented for departing from the traditional ratemaking methodology of applying a fair value rate of return to the Company's FVRB in this proceeding. For the reasons advocated by Staff and RUCO, we find that applying a fair value rate of return to the FVRB is just, reasonable, and in accord with the mandates of the Arizona Constitution, and will adopt it in this case.

IX. AUTHORIZED INCREASE/DECREASE

With the adjustments adopted herein, the adjusted test year operating income is $614,247. The 7.6 percent cost of capital translates into a 6.36 percent fair value rate of return on FVRB of $20,340,298 as authorized hereinabove. Applying the 6.36 percent rate of return to the FVRB produces required operating income of $1,294,338. This is $680,091 more than the Company's test year adjusted operating income. Multiplying the deficiency by the gross revenue conversion factor of 1.6286 results in an increase in revenues of $1,107,596, or a 17.86 percent net increase over test year adjusted revenues.

X. RATEDESIGN

In its rate application, the Company proposed a two-tier, inverted block rate design, with different breakover points for each size meter based on its cost of service study (Kozoman Dt. at 11-20, Exh. A-14, Sched. G-1 through G-9). In its rebuttal filing, the Company accepted nearly all of the elements of Staffs proposed rate design, including the use of three inverted commodity rate tiers for residential customers on ¾-inch meters, with all other customers having two inverted commodity rate tiers; Staffs recommended breakover points between tiers; elimination of the current additional charge to recover costs for pumping water to elevation zones two and three; elimination of the 1,000 gallons of water in the monthly minimum charge; and the continuation of a single, uniform volume rate for irrigation water service (Kozoman Rj. at 34, Tr. at 771-74). Staffs recommended breakover

points for %-inch residential meters are 3,000 gallons and 9,000 gallons; and for %-inch commercia and industrial meters, one breakover point of 9,000 gallons; with increasing single breakover point as meter sizes increase. The Company states that it recognizes the importance of encouraging wate conservation, including the use of rate design to encourage customers to implement conservatio measures and reduce their water use (Co. Reply Br. at 37). The Company disagrees, however, wit Staffs recommended spread between the commodity rates and also with the commodity rates Staf recommends for irrigation water service.

Chaparral City contends that Staffs recommended inverted tier rate design with its proposec spread between commodity rates may lead to reduced water use by customers, and that if it does, the -ate design will impact its ability to earn its authorized rate of return. The Company believes thai Staff is actually proposing a "lifeline" rate because Staffs recommended commodity rate for the first ier is below the Company's existing commodity rates, and is only applicable to residential customers on ¾" meters, and that Staff is using the subsidy of the lower rate for first tier usage to create a larger spread between the tiered commodity rates. The Company asserts that rates should be designed in a way that accounts for possible reductions in water use (Co. Br. at **54-55),** and urges that the risk that a new rate design may lead to under-recovery of the Company's authorized revenue requirement hould be recognized in the return on equity authorized in this proceeding *(Id.* at 58). Taking the lternative point of view, the Company also argues on brief that if Staffs recommended rate design will not reduce existing customers' water usage, it should not be required to implement inverted tier ates (Co. Br. at 59).

Staff asserts that its inverted tier rate design was developed to promote long term conservation oals, and includes commodity rates that are spread far enough apart to send appropriate price signals o customers regarding the importance and value of water, which is a limited resource in this state. taff disputes the Company's assertion that its first tier is a "lifeline" rate, because its proposal is not

designed according to income level, but instead is focused on sending an appropriate price signa based on customers' meter size and usage (Staff Br. at 4). Staff states that it cannot predict whether customers will actually decide to use less water in a particular year; that no evidence was presented supporting the Company's claim that there will be a significant short-term change in water use as a result of the implementation of inverted-tier rates; and that the Company's service area still has a rapidly-growing customer base (Staff Reply Br. at 3).

RUCO proposes a rate design that charges each customer the same commodity rate for the same level of usage (RUCO Br. at 14). RUCO's three tier inverted block rate structure has its first breakover point at 8,000 gallons, the present average residential usage, with the second breakover point at 73,000 gallons, which it calculated based on the average of the Company's original proposed graduated breakover points (Moore Dt. at 32). RUCO believes this rate design provides a balanced approach that does not discriminate between classes or meter sizes, and that since its breakover points are based on average customer usage, provides a price incentive against above-average use, which would result in the conservation of water resources (RUCO Reply Br. at 9).

The Company disagrees with RUCO's rate design because it shifts revenue recovery away from residential customers, who have smaller meters, and onto commercial and industrial customers, who have larger meters. The Company believes that RUCO's rate design is inequitable to customers on larger sized meters because customers with smaller meters will have a substantial portion of their usage fall into the lower-priced rate block, with little of their usage reaching into the highest price rate block, while customers with larger meters will have the bulk of their usage fall into the higher ers, without regard to whether their water usage is excessive or wasteful.

Of the rate designs presented, we find that Staffs proposal best addresses the goals of conservation, efficient water use, affordability, fairness, and simplicity.[8] We find also that the risk of

[8] Public comment was presented concerning the Company's irrigation rates as originally proposed by the Company. We ste that the irrigation commodity rate we approve herein remains lower than other commodity rates.

revenue instability that the Company fears is sufficiently offset by the current growth in the Company's customer base to allow the implementation of a conservation-oriented rate design at this time. Although the Company provided testimony speculating that Staff's proposed rate design might cause such drastic reductions in water usage that the Company would be unable to recover its authorized revenue requirement, we do not find this conjecture convincing. As Staff's uncontroverted growth analysis demonstrates, the Company still has a growing customer base (*see* Scott Dt., Exhibit MSJ at 5), and new growth will be available to compensate for possible reductions in usage by existing customers, if demand proves to be elastic and existing customers respond to the conservation signals by reducing their usage in response to the new rate design. If, even with customer growth, the Company finds it is not recovering its authorized revenue requirement, it is within the Company's control to file a rate case. After considering the evidence presented, we find hat it is in the public interest for the Company to implement the conservation-oriented rate design roposed by Staff.

XI. OTHER ISSUES

A. Automatic Adjustment Mechanisms

The Company requests approval to implement automatic adjustment mechanisms which would allow the Company to directly pass through to its ratepayers increases and decreases in two of :s most significant operating expenses, purchased water and power costs, through a surcharge iechanism.[9] Staff and RUCO recommend against approval of the requested adjustment iechanisms.

Approximately 90 percent of the Company's water supply comes from Central Arizona roject ("CAP") water delivered through the Central Arizona Water Conservation District 'CAWCD") (Hanford Rb. at 3). Under its subcontract with the United States and CAWCD,

[9] Adjusted test year purchased water costs are $823,781 and adjusted test year purchased power costs are $510,947.

Chaparral City pays an annual water service capital charge, based on its total CAP allocation, and a separate delivery charge based on the amount of CAP water actually used (Hanford Dt. at 6). Chaparral City is also a member of the Central Arizona Groundwater Replenishment District ("CAGRD") administered by CAWCD. The Company pays fees to the CAGRD for groundwater replenishment services based on the quantity of ground water pumped (Hanford Dt. at 6-7). The Company's witness claims that based on the advisory rates published by CAWCD for the years 2006. 2007 and 2008, purchased water costs will increase over the adjusted test year level by more than $50,000 per year by 2008 and that these increases will amount to over $100,000 of unrecovered water expense over the three year period (Bourassa Rj. at 24).

Chaparral City purchases power from both APS and SRP. The Company projects annual expense increases from SRP and APS of over 5 percent per year over adjusted test year levels (Co. 3r. at 24).

Staff agrees that the Company's purchased water costs are significant, but in contrast to the Company's estimate that its purchased water expense will increase by more than $50,000 per year, Staffs analysis of advisory rates showed that the Company's purchased water expense will not ncrease over test year levels by $50,000 until 2008 (Exh. S-7, Exh. 5). Staff does not believe that the ncremental cost level or volatility associated with possible rate increases or decreases associated vith the Company's water supply are significant enough to justify a purchased water adjustment nechanism in this case, and recommends denial of the Company's request. Regarding purchased power expense, Staff does not disagree that purchased power expense is a significant cost for Chaparral City, but points out that the issue to be considered in implementing an adjustment nechanism is not merely whether the cost is significant, but whether the incremental cost level, or volatility, associated with possible rate increases or decreases is significant. Staff asserts that the future rate increases the Company projects from SRP and APS do not constitute a level of volatility

great enough to warrant the need for a purchased power adjustment mechanism. In particular, Staf differentiates the possible increases in Chaparral City's purchased power expense from the volatilit of APS' constantly changing fuel and purchased power costs, which led to the Commission's recen approval of a Power Supply Adjustor for APS.

We do not disagree with the Company that its purchased water and purchased power expense: are significant. However, we agree with Staff and RUCO that these expenses do not constitute a level of volatility that would justify the extraordinary ratemaking treatment that the Company requests. As we stated in Decision No. 56450, there is a danger of piecemeal regulation inherent ir adjustment mechanisms. Because adjustor mechanisms allow automatic increases in rates without a simultaneous review of a Company's unrelated costs, an adjustment mechanism has a built-ir potential of allowing a Company to increase rates based on certain isolated costs when its other costs are declining, or when overall revenues are increasing faster than costs due to customer growth. Such circumstances can result in increases to ratepayers through adjustors even when the Company's level of earnings would not warrant a rate increase, such that the utility's net income is increased outside a rate case. In addition, as we stated in Decision No. 66849 (March 19, 2004), adjustment mechanisms may also provide a disincentive for a utility to obtain the lowest possible cost commodity because the costs are simply passed through to ratepayers. For these reasons, adjustment mechanisms should be implemented only under very special circumstances. Based on the evidence in this proceeding, circumstances do not exist in this case to justify the risks of piecemeal regulation inherent in adjustment mechanisms, and we will not approve the Company's requests.

On July 28, 2005, the Company filed a request that administrative notice be taken of an application filed on July 22, 2005 in Docket No. E-01345A-05-0526 by APS requesting recovery of 100 million in unrecovered fuel and purchased power costs through the Power Supply Adjustor mechanism approved in Decision No. 67744 (April 7,2005). The July 28,2005 filing also requested

that administrative notice be taken of SRP's announcement that it intends to increase its residentia and business rates on or about November, 2005. The Company asserts that the APS filing and the SRP announcement are relevant to its request for authorization of a purchased power adjustmeni mechanism.

We note that the Commission has not ruled on the APS PSA request, and that the SRP announcement indicated an effective date of November 2005. This means that future changes in SRP's rates, and any changes to APS' rates resulting from its July 22, 2005 filing, will take place more than one and a half years following the end of the 2003 test year in this case. As explained above, the expenses we approve herein already include an adjustment for known and measurable post-test year changes in the Company's electricity costs. The Company indicated that it is likely to file another rate case within three to four years (Tr. at 647; Bourassa Dt. at 14). If the Company experiences a further increase in costs during 2006 as a result of the anticipated SRP increase, or as a result of a Decision on the APS filing, it will be appropriate to examine such increases in the context of the Company's other concurrent expenses, rather than simply authorizing the Company to pass those costs through to ratepayers.

B. Depreciation Rates

The Company is proposing to utilize the depreciation rates proposed by Staff on a going forward basis. Staff has developed typical and customary depreciation rates within a range of anticipated equipment life by individual National Association of Regulatory Utility Commissioners "NARUC") category (Scott Dt., Exhibit MSJ at 7, 16). These are the depreciation rates that have been adopted in recent rate cases (See, *e.g.* Decision No. 67279 (October 5,2004) (Rio Rico Utilities, Inc.)). RUCO disagrees with the use of these depreciation rates, which it states are among the highest rates the Commission has recently approved. In the absence of a depreciation study, which would have provided a definitive set of depreciation rates, RUCO proposes depreciation rates that it states

epresent an average of 24 different water systems. The Company criticizes the methodology RUCO ised to develop its proposed depreciation rates, because it mixes composite rates with individual iepreciation rates by plant category in order to calculate average rates, and because the resulting iepreciation rates were not compared with the expected useful lives of the assets to which they would ɔe applied (Tr. at 554-555). We find that the Staff proposal more closely estimates the expected life ɔf the Company's assets than RUCO's proposal, and will order the Company to adopt the typical and ;ustomary depreciation rates that Staff has developed as set forth in Mr. Scott's Direct Testimony, Exhibit MSJ at 16.

C. Cross-Connection and Backflow Prevention Tariff

Attached to Company witness Mr. Hanford's direct testimony was a proposed cross-connection and backflow prevention tariff. There was no objection or comment on the proposed tariff during this proceeding and the Company requested that it be approved. We will therefore approve it and require that a conforming copy of the tariff be filed along with the tariffs for its new rates.

D. Water Service Curtailment Tariff

Also attached to Mr. Hanford's direct testimony was a water service curtailment tariff. In Staffs direct testimony, Staff proposes an alternative form of tariff similar to tariffs approved in the past for Class **A** water utilities. The Company is in agreement with Staffs proposed form of tariff and requests that it be approved. Staff recommends that the Company be directed to file a copy of a water service curtailment tariff within 45 days of this Decision, for Staffs review and certification. We will therefore direct the Company to file a copy of the tariff in conformance with the form of tariff attached to the direct testimony of Mr. Scott in Exhibit MSJ at 8, within 45 days of this Decision, for Staffs review and certification.

E. Non-Account Water

Staff notes in its direct testimony that Chaparral City's non-account water was over 11 percent, which exceeds Staffs recommendation that non-account water should be 10 percent or less. Staff states that the Company is aware of its non-account water and believes that some of its meters are being under read and that the Company is currently monitoring its meter reading practices. Staff recommends that the Company docket the results of meter monitoring as a compliance item in this case by July 30,2006; that if the reported water loss for the period from June 1,2005 through June 1, 2006 exceeds 10 percent, that the Company be required to prepare either a report containing a detailed analysis and a plan to reduce non-account water to below 10 percent, or to submit a cost-benefit analysis demonstrating that it is not cost-effective to reduce non-account water below 10 percent. The Company did not object to Staffs recommendation. We will adopt Staffs recommendation in this case.

F. Arsenic Issues

As noted above, 90 percent of Chaparral City's water supply consists of treated CAP water. However, the Company has two active wells, Well Number 10 and Well Number 11, which show concentrations of arsenic slightly above the 10 parts per billion maximum contaminant level ("MCL") for arsenic that will become effective in January, 2006 (Scott Dt., Exh. MSJ at 5). Staff notes in its direct testimony that a blend line has already been constructed to Well Number 10 and that the Fountain Hills Boulevard main will be used to blend CAP water with ground water from Well Number 11 *(Id.)*. The Company does not object to Staffs recommendation that the Company be required to submit, by November 30, 2005, a plan describing how the Company will comply with the new arsenic MCL when the CAP canal is out of service. We find this recommendation to be reasonable and will adopt it.

* * * * * * * * * *

Having considered the entire record herein and being fully advised in the premises, the Commission finds, concludes, and orders that:

FINDINGS OF FACT

1. Chaparral City is a public service corporation engaged in providing water utility service to approximately 12,000 customers located in the northeastern portion of the Phoenix metropolitan area, including the Town of Fountain Hills and a small portion of the City of Scottsdale under authority granted by the Commission in Decision No. 41243 (April 20, 1971). The Company's business office is located at 12021 N. Panorama Drive in Fountain Hills, Arizona, 85268.

2. Chaparral City is currently charging rates approved in Decision No. 57395 (May 23, 1991), based on a test year ended December 31, 1988.

3. Chaparral City is an Arizona corporation wholly owned by American States Water Company, which is publicly traded on the New York Stock Exchange. American States' primary operating subsidiary is Southern California Water Company.

4. In October 2000, as approved in Decision No. 62909 (September 18, 2000), American States purchased Chaparral City's stock from MCO Properties, Inc., the real estate developer that owned and operated Chaparral City.

5. On August 24, 2004, Chaparral City filed with the Commission an application requesting an increase in revenues of $1,797,182.

6. On September 14, 2004, RUCO filed an Application to Intervene, which was granted. No other requests for intervention were filed.

7. On September 23, 2004, Staff filed a letter stating that the Company's application met the sufficiency requirements set forth in A.A.C. R14-2-103, and classifying the Company as a Class A utility.

8. On September 28, 2005, a Procedural Order was issued setting this matter for hearing and setting related procedural deadlines.

9. On February 15, 2005, the Company filed a Notice of Publication certifying that public notice was published in *The Fountain Hills Times* on January 26, 2005. Public notice of the

application and hearing was also mailed to each of the Company's customers in their January 200[illegible] bills.

10. Written public comments in opposition to the amount of the requested rate increase were received on February 10, February 14, February 28, March 10, March 23, April 8, April 20 April 21, May 24, May 31,[10] and June 14,2005.

11. A hearing was held as scheduled commencing on May 31, 2005 and continuing on rune 1, June 6 and June 8,2005.

12. Public comment opposing the proposed increase in irrigation rates was provided on "lay 31, 2005 by Ken Watkins, the golf course superintendent of the FireRock Country Club. Mr. Natkins also filed written public comment in this docket on March 23, 2005 and June 14,2005. Mr. Natkins stated that FireRock would be adversely impacted by the rate increase because even though he golf course uses effluent when possible, it sometimes must rely on potable water.

13. Public comment against the proposed increase in irrigation rates was also provided on hay 31, 2005 by Joe Miller, the golf course superintendent of The Golf Club at Eagle Mountain. Mr. hiller also stated that his golf course sometimes must use potable water for irrigation, and that it vould be adversely affected by the proposed rate increase. Mr. Miller also filed written public omment in this docket on April 8,2005 and May 24,2005. Don Rea, the General Manager of The iolf Club at Eagle Mountain also filed a letter dated April 5, 2005 opposing the increase in irrigation ates on April 21, 2005 and again May 24,2005.

14. For ratemaking purposes, Chaparral City's OCRB, RCND and FVRB for the test year nded December 31, 2003 are determined to be $17,030,765, $23,649,830, and $20,340,298, espectively.

15. With the adjustments adopted herein, the adjusted test year operating income is 614,247.

16. The 7.6 percent cost of capital translates into a 6.36 percent fair value rate of return on VRB of $20,340,298 as authorized hereinabove. Applying the 6.36 percent rate of return to the

[10] The public comment letter filed on May 31,2005 (the date the hearing commenced) included a request by a customer at a "rate adjustment" made in 2003 be investigated. If the Commission's Consumer Services Section has not already one so, it should promptly contact this customer, and inform the Commission if further action is required.

FVRB produces required operating income of $1,294,338. This is $680,091 more than the Company's test year adjusted operating revenue. Multiplying the deficiency by the gross revenue conversion factor of 1.6286 results in an increase in revenues of $1,107,596, or a 17.86 percent net increase over test year adjusted revenues.

17. The rates set herein result in a monthly increase of $3.83, from $30.49 to $34.32, or 12.57 percent, for the average usage residential customer (9,187 gallons), and a monthly increase of $2.41, from $22.53 to $24.94, or 10.70 percent, for the median usage (5,501 gallons) residential customer.

18. The rate of return methodology and resulting revenue increases proposed by Chaparral City would produce an excessive return on FVRB.

19. It is in the public interest to implement a rate design that promotes long-term conservation goals.

20. The rate design approved herein addresses the goals of conservation, efficient water use, affordability, fairness, simplicity, and revenue stability, and is in the public interest.

21. The methodology adopted herein for estimation of property tax expense fairly estimates property tax expense.

22. Based on the evidence presented, circumstances do not exist in this case to justify the risks of piecemeal regulation inherent in adjustment mechanisms, and Chaparral City's request to implement automatic adjustment surcharge mechanisms for its purchased power and purchased water costs will not be approved.

23. The typical and customary depreciation rates developed by Staff as set forth on page 6 of Exhibit MSJ attached to the Direct Testimony of Staff witness Mr. Scott are just and reasonable and should be used by Chaparral City on a going-forward basis.

24. The cross-connection and backflow prevention tariff attached to the Direct Testimony of Mr. Hanford is reasonable and should be approved. Chaparral City should be required to file a conforming copy of the tariff when it files the tariffs setting forth the new rates we approve herein.

25. Staffs recommendation that the Company be directed to file a copy of a water service curtailment tariff that conforms to the form of tariff attached to the direct testimony of Mr. Scott in

Exhibit MSJ at 8, within 45 days of this Decision, for Staffs review and certification, is reasonable and should be adopted.

26. Staffs recommendation regarding meter monitoring and reporting in relation to Chaparral City's 11 percent test year level of non-account water is reasonable and should be adopted.

27. Staffs recommendation that Chaparral City be required to submit, by November 30, 2005, a plan describing how it will comply with the new arsenic MCL when the CAP canal is out of service, is reasonable and should be adopted.

28. Because an allowance for the property tax expenses of Chaparral City Water Company, Inc. is included in the Company's rates and will be collected from its customers, the Commission seeks assurances from the Company that any taxes collected from ratepayers have been remitted to the appropriate taxing authority. It has come to the Commission's attention that a number of water companies have been unwilling or unable to fulfill their obligation to pay the taxes that were collected from ratepayers, some for as many as twenty years. It is reasonable, therefore, that as a prophylactic measure Chaparral City Water Company, Inc. annually file, as part of its annual report, an affidavit with the Utilities Division attesting that the Company is current in paying its property taxes in Arizona.

29. As discussed herein, it is reasonable to require Chaparral City to cease charging hook-up fees until such time that it has an approved hook-up fee tariff on file.

30. The Maricopa County Environmental Service Department has determined that the Company's system is currently delivering water that meets water quality standards required by Title 8, Chapter 4 of the Arizona Administrative Code.

31. The Company is located in the Phoenix Active Management Area ("AMA") and is therefore subject to the Arizona Department of Water Resources' water use and monitoring requirements. The AMA has reported that the Company is in compliance with its water use and monitoring requirements.

32. The fair value rate base, fair value rate of return, and rates and charges adopted herein are just and reasonable.

CONCLUSIONS OF LAW

1. Chaparral City is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. Sections 40-250 and 40-241.

2. The Commission has jurisdiction over the Company and the subject matter of the application.

3. Notice of the application was provided in the manner prescribed by law.

ORDER

IT IS THEREFORE ORDERED that Chaparral City Water Company, Inc. is hereby directed to file with the Commission on or before September 30, 2005, the following revised schedules of rates and charges:

MONTHLY USAGE CHARGE:
(All Zones and Classes)

¾" Meter	$ 13.60
1" Meter	22.70
1 ½" Meter	45.40
2" Meter	73.00
3" Meter	146.00
4" Meter	227.00
6" Meter	454.00
8" Meter	730.00
10 Meter	1,043.00
12 Meter	1,980.00
Fire Hydrants - Basic Service	No Monthly Usage Charge
Fire Hydrants – Used for Irrigation	$146.00

Commodity Rates Per 1,000 Gallons

¾" Meter (Residential)	
From 1 to 3,000 Gallons	$1.68
From 3,001 to 9,000 Gallons	2.52
Over 9,000 Gallons	3.03
¾" Meter (Commercial and Industrial)	
From 1 to 9,000 Gallons	2.52
Over 9,000 Gallons	3.03
1" Meter (Residential, Commercial and Industrial)	
From 1 to 24,000 Gallons	2.52
Over 24,000 Gallons	3.03

1½" Meter (Residential, Commercial and Industrial)	
From 1 to 60,000 Gallons	2.52
Over 60,000 Gallons	3.03
2" Meter (Residential, Commercial and Industrial)	
From 1 to 100,000 Gallons	2.52
Over 100,000 Gallons	3.03
3" Meter (Residential, Commercial and Industrial)	
From 1 to 225,000 Gallons	2.52
Over 225,000 Gallons	3.03
4" Meter (Residential, Commercial and Industrial)	
From 1 to 350,000 Gallons	2.52
Over 350,000 Gallons	3.03
6" Meter (Residential, Commercial and Industrial)	
From 1 to 725,000 Gallons	2.52
Over 725,000 Gallons	3.03
8" Meter (Residential, Commercial and Industrial)	
From 1 to 1,125,000 Gallons	2.52
Over 1,125,000 Gallons	3.03
10" Meter (Residential, Commercial and Industrial)	
From 1 to 1,500,000 Gallons	2.52
Over 1,500,000 Gallons	3.03
12" Meter (Residential, Commercial and Industrial)	
From 1 to 2,250,000 Gallons	2.52
Over 2,250,000 Gallons	3.03
Irrigation/Bulk (All Meters)	
All Gallons	1.56
Fire Hydrant Irrig./Const. (All Meters)	
All Gallons	1.56
(Standpipe) Fire Hydrants	

All Gallons	2.52		
Fire Sprinklers			
All Gallons	2.52		
~~Service Line and Meter Installation~~ Charges	~~Meter~~		Total
5/8" X ¾" Meter	$135.00	$385.00	$520.00
¾" Meter	215.00	385.00	600.00
1" Meter	255.00	435.00	690.00
1 ½"Meter	465.00	470.00	935.00
2" Turbine Meter	965.00	630.00	1,595.00
2" Compound Meter	1,690.00	630.00	2,320.00
3" Turbine Meter	1,470.00	805.00	2,275.00
3" Compound Meter	2,265.00	845.00	3,110.00
4" Turbine Meter	2,350.00	1,170.00	3,520.00
4" Compound Meter	3,245.00	1,230.00	4,475.00
6" Turbine Meter	4,545.00	1,730.00	6,275.00
6" Compound Meter	6,280.00	1,770.00	8,050.00
8" & Larger	At Cost	At Cost	At Cost
Establishment	$25.00		
Establishment (After Hours)	35.00		
Reconnection (Delinquent)	35.00		
Reconnection (Delinquent and After Hours)	50.00		
Meter Test	35.00		
Deposit Requirement (Residential)	*		
Deposit Requirement (Non Residential Meter)	*		
Hydrant Meter Deposit	50.00		
Deposit Interest	*		
Re-establishment (within 12 months)	**		
Re-establishment (after hours)	**		
NSF Check	25.00		
Deferred Payment, per month	1.50%		
Meter Re-read	25.00		
Charge of moving customer meter- Customer Requested	cost		
After hours service charge	Refer to above service charges		
Late Charge per month	1.50%		
Monthly Service Charge for Fire Sprinkler			
4" or smaller	$10.00		
6"	10.00		
8"	10.00		

10"	10.00
Larger than 10"	10.00

* Per Commission rule A.A.C. R-14-2-403(B).

** Months off system times the monthly minimum per Commission rule A.A.C. R14-2-403(D).

*** 1% of monthly minimum for a comparable size meter connection, but no less than $5.00 per month. The service charge for fire sprinklers is only applicable for service lines separate and distinct for the primary water service line.

In addition to the collection of regular rates, the utility will collect from its customers a proportionate share of any privilege, sales, use and franchise tax, per Commission Rule R14-2-409D(5).

All advances and/or contributions are to include labor, materials, overheads and all applicable taxes, including all gross-up taxes for income taxes, if applicable.

IT IS FURTHER ORDERED that the revised schedule of rates and charges approved herein hall be effective for all service rendered after September 30,2005.

IT IS FURTHER ORDERED that Chaparral City Water Company, Inc. shall notify its ustomers of the revised schedules of rates and charges authorized herein by means of an insert in its ext regularly scheduled billing in a form and manner acceptable to the Commission's Utilities)ivision Staff.

IT IS FURTHER ORDERED that the cross-connection and backflow prevention tariff ttached to the Direct Testimony of Mr. Hanford is hereby approved.

IT IS FURTHER ORDERED that Chaparral City Water Company, Inc., shall file in Docket lontrol, as a compliance item in this case, a conforming copy of the cross-connection and backflow revention tariff approved herein by September 30,2005.

IT IS FURTHER ORDERED that Chaparral City Water Company, Inc. shall file in Docket 'ontrol, as a compliance item in this case, within 45 days, a water service curtailment tariff onforming to the form of tariff attached to the direct testimony of Mr. Scott in Exhibit MSJ at 8. for taff s review and certification.

IT IS FURTHER ORDERED that Chaparral City Water Company, Inc. shall file in Docket 'ontrol, as a compliance item in this case, by November 30, 2005, a plan describing how it will imply with the United States Environmental Protection Agency rule regarding the maximum

contaminant level for arsenic when the Central Arizona Project canal from which it takes water delivery is out of service.

IT IS FURTHER ORDERED that in recognition of ongoing drought conditions in Arizona, the Company shall provide the Commission within 1 year of the effective date of this order detailed plans on how the Company's customers could increase the use of effluent and reduce their reliance on groundwater specifically as it pertains to golf courses, ornamental lakes and other aesthetic water features.

IT IS FURTHER ORDERED that Chaparral City Water Company, Inc. shall annually file, as part of its annual report, an affidavit with the Utilities Division attesting that the Company is current in paying its property taxes in Arizona.

IT IS FURTHER ORDERED that Chaparral City Water Company, Inc. shall cease charging hook-up fees until such time that it has an approved off-site facilities hook-up fee tariff on file.

IT IS FURTHER ORDERED that Chaparral City Water Company, Inc. shall adopt the typical and customary depreciation rates developed by Staff as set forth on page 16 of Exhibit MSJ attached to the Direct Testimony of Staff witness Mr. Scott.

IT IS FURTHER ORDERED that Chaparral City Water Company, Inc. shall file in this docket, as a compliance item in this case, by July 30,2006, the results of its meter monitoring for the period from June 1,2005 through June 1,2006. If the reported water loss for the period from June 1, 2005 through June 1, 2006 exceeds 10 percent, Chaparral City Water Company, Inc. shall file, by September 30, 2006, either: 1) a report containing a detailed analysis and a plan to reduce non-account water to below 10 percent, or 2) a cost-benefit analysis demonstrating that it is not cost-effective to reduce non-account water below 10 percent.

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IT IS FURTHER ORDERED that Chaparral City Water Company, Inc.'s requests for approval of automatic adjustment mechanisms for its purchased water costs and purchased power costs are hereby denied.

IT IS FURTHER ORDERED that this Decision shall become effective immediately.

BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

CHAIRMAN COMMISSIONER

COMMISSIONER COMMISSIONER COMMISSIONER

IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive Director of the Arizona Corporation Commission, have hereunto set my hand and caused the official seal of the Commission to be affixed at the Capitol, in the City of Phoenix, this 30th day of Sept., 2005.

BRIAN C. McNEIL
EXECUTIVE DIRECTOR

DISSENT _____

DISSENT _____

SERVICE LIST FOR: CHAPARRAL CITY WATER COMPANY

DOCKET NO.: W-02113A-04-0616

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